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"What a country wants to make it richer, is never consumption, but production. Where there is the latter, we may be sure that there is no want of the former. To produce, implies the desire to consume."

John Stuart Mill
Essay on Some Unsettled Questions, 1844

HIGHLIGHTS

Looking at the world economy, there is nothing to cheer about. Contrary to the latest swell of optimism, the world business climate has deteriorated sharply over the past six to eight weeks.

Worldwide, economic and monetary data point to a progressive slowdown in economic activity. After Japan fell prey to this downturn earlier in the year, it's now Europe's turn to succumb.

Is the latest U.S. dollar spurt the start of something bigger? Our analysis leads to the conclusion that this is just another in a long series of deceptive fake-outs for both the U.S. economy and the dollar. The dollar remains in a long-term downtrend.

The deteriorating U.S. trade balance and the fading of the big fiscal stimulus of earlier this year points to an imminent "triple dip" for the U.S. economy. In terms of the gap between actual and potential growth, the present U.S. recession is already the deepest of the postwar period.

The key thing to see is that the U.S. has already benefited from a hefty fiscal stimulus over the last year. Critically, this massive effort along with drastically reduced interest rates has failed to kindle a self-propelling recovery. What's left for an encore?

One deficit country after another — Australia, Canada, and Britain, too — are capitulating to the trials of sluggish economies. They're tempted to return to the days of limitless deficit-spending and easy money . . . the exact same things that got them into trouble in the first place.

For the U.S. and the other deficit countries, the most important depressive influences remain in full force — record-low credit and broad-money growth, employment and income growth weakness, overindebtedness, still-low savings, and a real estate and banking crisis.

We've repeatedly warned that the U.S. bond market owed its bullish uptrend to aggressive interest rate speculation. The bond market remains highly vulnerable. The low supply of savings is its Achilles' heel.

Conservative investors must not lose sight of long-term trends during the many short-term whipsaws that they are likely to face. Continue to focus on hard-currency bonds — the top-quality government bonds of Germany and Switzerland as well as Austria, Belgium and the Netherlands.

NO TURNING BACK NOW

It's a striking contrast: fading activity in the real economies and increasingly feverish action and volatility in international markets — stocks, bonds, currencies and derivative markets. It's a sign of desperation and confusion. Speculators and investors are being whipsawed by rapid, sharp swings in market expectations oscillating between manically depressive and gullibly euphoric whether it concerns the future course of various world economies or imminent policy changes. Within the span of mere weeks, analysts swing from trumpeting warnings about a deepening U.S. recession and a dollar crisis to joining in the euphoric gush behind a soaring dollar replete with optimistic forecasts of a newly-hatched recovery.

When markets become as erratic as they now are, guessing short-term moves from week to week and month to month becomes a futile mug's game; all the better to focus on predictable longer-run outcomes instead. Sticking to the underlying economic, financial and monetary fundamentals, we must again stress our growing disagreement with the latest consensus view that's sprouted up in the markets: a robust U.S. economic recovery, driven by Clinton deficit spending.

NO STOMACH FOR COLD TURKEY

Only a short while ago, the collective wisdom was that a Clinton victory, supposedly implying a new surge in U.S. deficit spending, would scare the bottom out of U.S. financial markets. But since new weakness in the economic data has convinced many that lower interest rates alone are unable to revive the economy, all of a sudden, fiscal stimulus is again respectably in vogue on Wall Street. What's more, scenting the halcyon "feel good" days of Reaganomics, many economists are longingly recalling how good the rising budget deficits were to the U.S. economy, the equity and bond markets and the dollar — at least for a time . . . never mind the long-run consequences. These economists have a very selective memory; the deficits were the main causes that led to the current troubles in the first place.

We have always railed against big deficit spending because of its long-term corrosive impact on the foundations of economic growth. The damage occurs as government deficits give rise to a boost in consumption at the expense of investment, the latter being the key determinant of higher productivity which in turn leads to solid, high-paying jobs and higher living standards.

It is undisputed that deficit spending, as long as it keeps rising, tends to exert a direct demand stimulus on the economy. The trouble with this kind of stimulant, though, is that it needs to be applied in ever larger doses to maintain the same rosy glow of demand growth. Like the sad fate of a drug addict, once the injections level out or diminish, painful withdrawal symptoms — shakes and contractions or worse — set in. Deficits are stimulative in the short run; they are depressive and destructive over the long run.

A RETURN TO DEFICIT SPENDING

As we look around the world, budget deficits are soaring in nearly every country, keeping long-term interest rates much higher than is justified for the weak economies. Remarkably, the worst cases are the long-time deficit countries that already have large budget deficits to start with, particularly the United States, Britain, Australia and Canada.

What can be expected to result from a new fiscal stimulus in the U.S.? Can it produce the economic recovery which easy money and lower interest rates have so far been unable to do? Before we address that question, let's first review the most recent massive fiscal stimulus: the one that President Bush has applied during the past 12 months without much fanfare, surely with an eye on the presidential election.

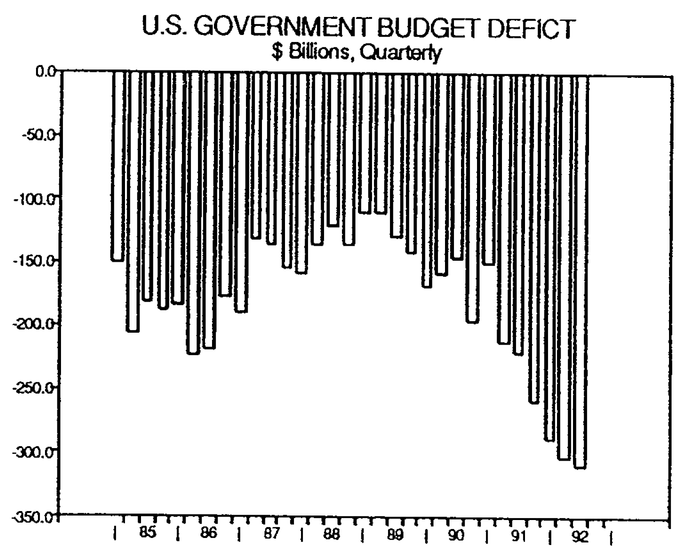
During the first half of 1992, the Federal deficit ran at an annual rate of $294 billion, up steeply from the $181 billion level in the first half of 1991. Within one year, the deficit jumped by a staggering $113 billion or more than 60%. These figures, as large as they are, actually understate the true size of the demand stimulus. How so? Not wanting the messy issue of widespread bank failures making headlines during an election year, the authorities virtually stopped spending on bank and thrift bailouts and instead instituted a temporary reduction in personal withholding tax rates and a big increase in social security benefits. These latter expenditure items surged by more than 12% against a year ago.

What did this costly pre-election burst in deficit spending achieve? It accomplished a short-lived spurt in consumer spending, lasting barely through the first quarter of 1992. After having stalled in the fourth quarter of 1991, real consumer spending rose in the first quarter of 1992 at an annual rate of 5.1%. This massive shot of consumer purchasing power clearly prevented an immediate deepening of the recession.

A NEW DEFICIT SPENDING PUSH HAS ALREADY HAPPENED

Remarkably, Wall Street hasn't paid any attention to this latest deficit explosion. President Bush still enjoys the reputation of being a fiscal conservative, as one who rigorously trimmed the budget deficit. Actually, he did and he didn't. It depends on which budget deficit one compares against, the actual deficit of the 1991 fiscal year or the one that was initially projected for 1992. Last January, the administration projected a mammoth budget gap of $400 billion for 1992. Now that the final spill of red ink has come in at "only" $290 billion, it's seen as a feat of conservatism. Never mind that it's still 60% bigger than the year before. Such a deficit shortfall, the biggest ever recorded, surely qualifies Mr. Bush as an austere deficit fighter.

Yet, how could such big savings from the projected budget deficit have come about? Was it all smoke and mirrors? Mostly, but not entirely. As we already pointed out, the much smaller budget deficit had its main reason in Congress' failure to approve new funds for the bank and thrift bailout. Spending on deposit insurance and asset purchases of failed thrifts almost ceased during the year as compared to the originally projected costs of $70-80 billion. The accumulated bill as well as the cost of new bailouts is of course next year's problem.



Source: Federal Reserve Bank of St. Louis

A big unknown looms after December 19th of 1992. A law enacted last year compels federal regulators to apply stricter (increased) capital requirements for banks and thrifts as of that date. Banks with a capital ratio of less than 2% will be deemed insolvent and will have to be closed in 90 days. It's surely not an incentive for the banks to increase loans. In any case, it's a sure bet that bailout expenditures will again surge after that point.

Looking back, it's important to recognize that there already has been a substantial fiscal stimulus under President Bush during the last 12 months, contrary to common perception. (See chart on the previous page.) Together with the Fed's drastic monetary easing, the resulting policy mix has contributed an immense fillip for the U.S. economy. **All important, however, was the obvious failure of this massive fiscal stimulus to trigger the self-propelling U.S. economic recovery that was widely forecast.** Is it really reasonable to expect that a still-bigger deficit (Clinton or otherwise) and even lower rates will make a difference? For a number of reasons, we doubt it.

THE "CATCH 22" OF DEFICIT SPENDING

In the 1930s, American economists used to call a policy of fiscal stimulus "pump priming." It was a term that was commonly used in the days of wells and cisterns. One would prime a dry pump by pouring water into its top while pumping the handle until it began to catch a self-maintaining suction. It was a temporary procedure and was only successful if the pump was in good working order to begin with. As with economies, pump priming can only succeed in restoring growth when the business mechanism of the country is functioning healthily.

What about the outlook for the budget deficit? The new president will start with a budget deficit already running at $300 billion even before the additional spending bill for both new and deferred bailouts and off-balance sheet items. Up until recently, the bond market didn't care a snick about the soaring deficit. Everybody was happy with the assumption that persistent economic weakness guaranteed low inflation and a continuing, if not a progressive, monetary easing. In this environment, U.S. bonds looked virtually riskless, while the record-low short-term interest rates acted as an irresistible invitation to play the higher-yielding bond market with borrowed short-term money. Accordingly, the U.S. bond market has been teeming with speculators.

But, alas, the party has been spoiled. Clinton's fiscal "growth package" and the Fed's refusal to oblige with another pre-election interest-rate cut was sufficient to send the bond market reeling. The quick, sharp price falls at the long end of the bond market — rates rising from 7.25% to 7.65% in the space of only six weeks — confirmed its extraordinary vulnerability. Short rates, too, bumped up rising from a low of 2.61% in early October to as high as 3.02% just three weeks later.

We've repeatedly warned that the U.S. bond market owed its bullish uptrend to aggressive interest-rate speculation and little else. That was all too obvious knowing the horribly misaligned supply and demand conditions of this market: that is, soaring bond supply on the one hand and the poor flow of domestic savings on the other. In the second quarter of 1992, net issues of Treasury and government agency bonds hit a record total of $551 billion measured at an annual rate. That was twice as much as was available from household savings and compares with a much lower $297 billion in net issues in 1989 and $414 billion in 1990.

Who, then, were the big buyers of U.S. Treasury bonds in the second quarter? There were two prominent buyers: firstly, commercial banks accounting for $102 billion in treasury bond purchases, of which U.S. chartered banks bought $76 billion and foreign affiliates another $27 billion; and secondly, foreign purchasers — central banks, $53 billion; other foreigners, $57 billion. Banks and foreigners clearly played a key role in driving the bull market in U.S. bonds.

What was it that lured the foreigners into U.S. bonds despite their internationally unattractive yields and

the weak dollar? Well, foreign banks and foreign investors, too, merrily played the steep U.S. yield curve, financing their bond purchases with cheap Federal funds and Euro dollars. Why use your own valuable money if you can take advantage of the Fed's largesse?

PLAYING THE US DOLLAR AGAIN

It seems all so familiar. All of a sudden, markets are fanning themselves into a frenzy on the anticipation of an imminent U.S. economic recovery. Both short and long-term interest rates, having been quickly jacked up, now help buoy the dollar. That's exactly the same way it happened early this year and the same time last year. Even the hollow arguments are the same. Actually, the reasons this time are even weaker than before. What's so convincing besides the popular theory that the best time to be bullish is when there is too much pessimism? Have the economic and monetary data in the United States suddenly turned around for the better? The great irony is that evidence of economic weakness is truly blatant at the moment and is very hard to ignore. The U.S. economy is drifting rudderless heading straight for an almost certain rendezvous with a "triple-dip."

Can the credit for this new-found euphoria really be given to Clinton's new growth package? Not hardly. It only amounts to an incremental first-year spending increase of $20-30 billion in a $5 trillion economy. When we compare this amount with Bush's ill-fated deficit binge last year and the size and investment needs of the U.S. economy, these numbers are really insignificant. Whether Clinton will and can do much more is another question. Given the extreme vulnerability of the U.S. bond market, we doubt that he can.

Looking at the anaemic U.S. economy and the persistently weak economic data, any thought of a Fed tightening in the foreseeable future is absurd. If anything, at least one more discount-rate cut seems likely. Any fiscal stimulus is simply going to be too small to vault the economy out of its sluggish rut.

All this never-ending bullish talk only proves to us that few people have really come to grips with the complex and deep-seated causes that underlie this unusually persistent recession in the United States and the other deficit countries. For four years (since early 1989) U.S. growth has averaged less than 0.5% per year. The only comparable period of slow growth was from 1979 to 1982. The weakness then was deliberately imposed by the extremely tight monetary policy of the Fed under Paul Volcker. This time, the near-stagnation persists in defiance of extremely easy money already for a period of three years.

THE CONFUSION ABOUT THE DEPTH OF RECESSION

Being preoccupied with the short-term, people fail to see the disastrous results that accumulate over time. Recently, the London-based Economist wrote: "*low growth is not a slump. America's recent slowdown has been so mild that it barely qualifies as a recession.*" This ill-informed, rosy perception uttered by the Economist is probably a good reflection of the consensus view.

Just what is a recession? In the United States, a recession is traditionally defined as two or more consecutive quarters of declining real GNP growth. By this measure, the current U.S. downturn appears to be short and mild. But while such a yardstick may be appropriate for the normal cyclical postwar recession that's lasted less than a year on average, it can't be applied in the fog of a long drawn-out economic slowdown which has already spanned several years.

The growth potential of an economy is not static; it always grows with productivity and labour force

growth. Near-stagnation over a longer period of time implies falling capacity utilization and rising unemployment. By this measure — the gap between actual and potential growth — the present U.S. recession is already one of the deepest in the postwar period though potential growth is at its lowest ever — barely 2% per annum compared with an average of 3.5% in the 1950-60s and 3% in the 1970-80s. Everybody knows and senses the deepening recession except the politicians and the economic experts.

YET ANOTHER RECOVERY PARADE

Contrary to the consensus which sees a U.S. recovery, we think that the economy is on the verge of a new downturn. The optimists stress that low interest rates, the easing of debt service burdens, improving business profits and the "gross undervaluation" of the U.S. dollar which strengthens U.S. competitiveness worldwide are evidence for their case. Our own bearish assessment derives from many indicators. Though we see the same improvements that the optimists confine their case to, the negative forces we identify as well, heavily overwhelm the beneficial steep fall of short-term interest rates.

In the first place, the lowering of interest rates is a one-off effect for which there is very little further leeway given the extremely low levels. The most important depressive influences remain in full force — high long-term rates, record-low credit and broad-money growth, employment and income growth weakness, overindebtedness, low savings, and a real estate and banking crisis. Our key indicators for the short-run are broad money and private credit. Both show no trace of life. Over the six months ending October 19, 1992, M2 is up 0.2% at an annual rate and M3 is down 0.8%.

Near-term, two main considerations point to an immediately deepening of the U.S.recession: firstly, the deteriorating U.S. trade balance; secondly, the fading of the big fiscal stimulus that temporarily boosted consumer spending earlier this year.

Exports have been the main prop for the U.S. economy during the past four years. If it weren't for soaring exports, the U.S. would surely have experienced a much deeper recession. But recently, the rapidly weakening world economy has caused this former prop to be transformed into a serious drag on GNP. Export-led growth is over. Any economic recovery for the U.S. from here must depend on domestic demand growth. Such growth prospects are no where to be seen.

A NEW U.S. DOLLAR TREND?

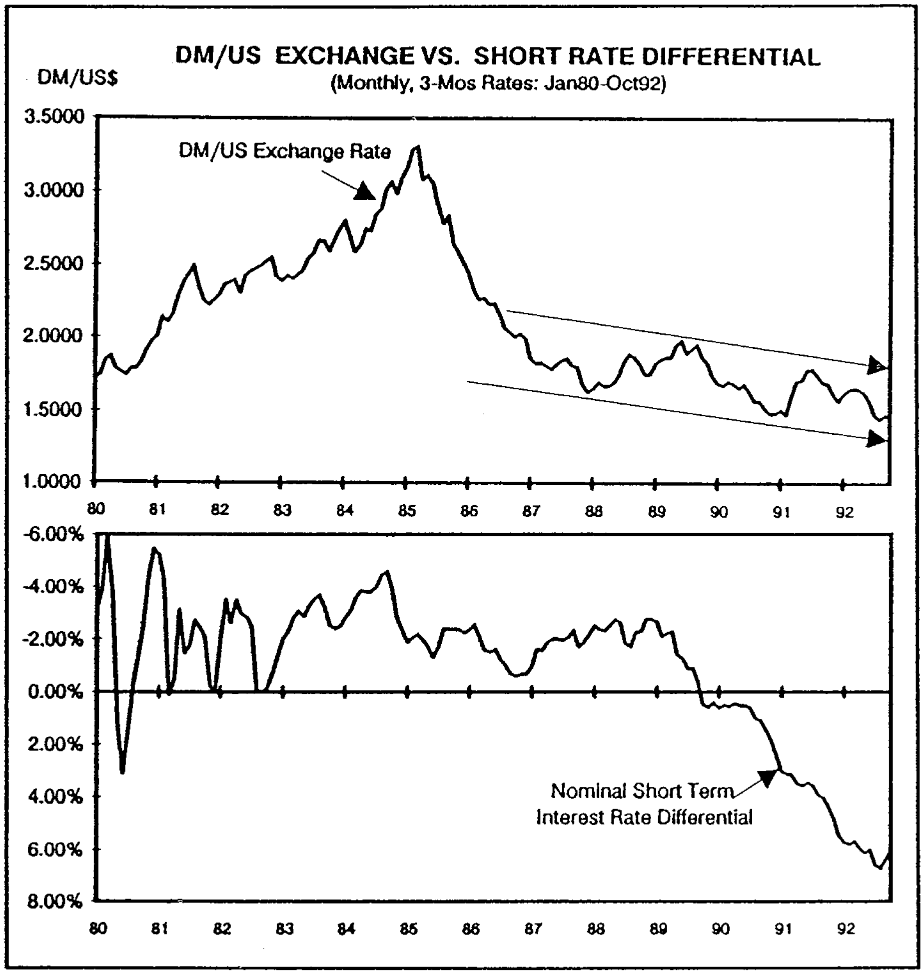
Recently, the currency markets have been gleefully swayed by a new dollar bull story. There are two elements to the dollar's rally: the belief that U.S. short-term interest rates have bottomed and also that the Bundesbank will now ease aggressively due to the perception that it has already made the first step in that direction. We challenge both assumptions. We've already expressed our disagreement with the former, and also think that the Bundesbank will move rates down only very slowly. But more on that later.

Being convinced that the U.S. dollar is grossly undervalued and that it therefore must rise sharply over the longer run, the international "dollar bull" fraternity clings to the explanation that it's only the large and widening interest rate advantage of the D-mark that causes this valuation disparity. Any narrowing of that huge interest gap — so the happy reasoning goes — will immediately catapult the dollar upwards. And, in fact, markets have followed this script in recent weeks. After falling back to near its all-time low in early October, the dollar has since shot up 10%. Is this the start of a significant uptrend for the dollar?

First off, trends in currency markets, as in most markets, never go in straight lines. If it were that way, predicting currencies would be much easier. One thing we have come to realize is that there is a persistent but false optimism among analysts and currency market participants about the underlying strength of the U.S. economy and the dollar. Although their rosy expectations have proved to be wrong time and again, it seemingly hasn't deterred them. One of the most visible evidences of this chronic false optimism is the unusual swiftness of any dollar rallies while the downtrends are much slower and stretched out. Yet, though the dollar bulls may not want to see the forest for the trees, the U.S. currency has made one new low after another despite the many zigs-zags.

THE THREE ESSENTIALS OF A STRONG CURRENCY

Just what should we make of the relative interest-rate trends in Germany and the U.S.? The two charts below which show the DM/$ exchange rate and the short-term DM/$ interest rate differential, provide some perspective. We would say that there is a weak relationship between these two series. Still, these charts aren't meaningless; they must be seen and interpreted from a wider economic context.



The first salient point to recognize is that German interest rates, apart from very short periods, were always lower than comparable U.S. rates. Even so, the D-mark has steadily risen against the dollar starting from a level of DM 4.00 when the currencies were first set floating. Why? Very simply: because over time, three crucial attributes tended to make up for the D-mark's interest rate disadvantage. They were (1) strong economic growth, (2) low inflation, and (3) a large, chronic trade and current-account surplus. These three elements are the distinctive ingredients of a truly strong currency. Just look at the performance of the yen.

Of these three essentials characteristics for a strong currency, the dollar presently possesses only one — lower inflation. The other two essentials — strong growth and a strong trade balance — are lamentably absent.

Markets anticipate, we are told, implying that markets must always be right. The sorry truth is that this is the fourth year in a row that forecasters and Wall Street have been wrong about the U.S. economy and the dollar. Originally, in 1989, there wasn't even supposed to be a recession to start with. In early 1991, Wall Street predicted recovery and then again early this year. In each case, the economy dipped instead.

Observing the frantic rush to get on the bandwagon every time a recovery is announced, it seems that forecasters have no memory recall. Fortunately, the futures markets nowadays give us some good clues as to what speculators are anticipating. According to interest-rate futures markets, German short-term interest rates are expected to fall to 6.6% one year from now while U.S. short-term interest rates rise to 5%. (Present rates are 8.75% and 2.96%, respectively.) These markets would have us believe that German rates would fall by more than 2% while U.S. rates rise by 2%.

Our expectation for DM short-rates are modestly higher — around 7% or so. The key point that we have some trouble with, though, is the sharp rise in U.S. rates. It tells us that this market — in line with the consensus — is betting on a very robust U.S. economic recovery. As explained earlier, we remain pessimistic about the U.S. economy. There are overwhelming signs that it is going in reverse rather than forward, thus forcing the Fed to lower interest rates further even though there may be hardly any room left on the downside. The day markets come to recognize this weakness, the rug will promptly be pulled out from under the dollar recovery.

THE BASIS FOR LONG-TERM DOLLAR PESSIMISM

Our dollar pessimism, however, has many more reasons. As we have always stressed, there are deeper structural causes behind the dollar's long-term decline. In this context, dollar weakness has two sources: the deepening recession in the short-run; and sharply diminished growth prospects due to a record-high budget deficit, widespread overindebtedness, record-low savings and investments, slow labour force growth, and a high trade and current account deficit over the long-run.

For us, what proves the superficial thinking of the dollar bulls is that they never mention the big and rising U.S. trade deficit. After all, it means that future dollar strength must depend on a corresponding and continuously high inflow of capital. Essentially, any forecast for the dollar boils down to the question of whether or not the capital inflows of the magnitude necessary for its support will materialize.

Leaving aside short-term currency speculation, such capital flows are dependent upon the attractions of relatively high interest rates, healthy profit and growth conditions and a promising economic outlook. None of these conditions are evident in the United States or any of the other deficit countries.

For centuries, economists have regarded the trade balance as the best available measure of a country's international competitiveness. Historically, trade or current-account deficits were always looked upon as signs of economic weakness except when they reflected booming investment in the deficit country. In the case of the United States and most other deficit countries, the currently large trade deficits clearly reflect exactly the opposite — overconsumption.

The highly disturbing characteristics of the chronic trade deficit and its underlying causes are drowned in empty talk about purchasing-power parity (PPP). These pundits don't even notice the ridiculous contradiction between Japan's soaring trade surplus and their assertion that the Japanese yen is overvalued against the dollar by as much as 40% by some calculations.

U.S. GROWTH FUNDAMENTALS: FROM BAD TO WORSE

America's current-account deficit peaked in 1987 at $163.5 billion. Presently, it's running at an annual rate of $50 billion and rising. No doubt, the drastic shrinkage since 1987 has certainly helped the dollar. The general assumption has been that this decline reflects improved competitiveness. We have always thought otherwise.

Our line of thinking is echoed exactly in a recent comment by the Federal Reserve Bank of St. Louis made in its August 1992 report, International Economic Conditions, Interpreting Recent Changes in the U.S. Current Account: *"While many observers view the changes in the U.S. current account favourably, an examination of the underlying causes suggests that a shrinking current account deficit does not necessarily reflect a healthy economy."*

What else can a shrinking current account mean? It used to be conventional wisdom that trade balances were primarily influenced by changes in relative demand conditions — in other words, by changes in the relative growth of different countries. Domestically, sharp increases in demand accelerates imports thereby increasing the trade deficit. Contrastingly, rising demand in the rest of the world — everything else being equal — has the opposite effect on the domestic economy: exports rise contributing to a trade surplus. Therefore, movements in a current-account surplus may not necessarily imply the obvious.

Between 1982 and 1987, U.S. domestic demand expanded at an annual rate of 4.3%; between 1988 and 1991 it grew at barely 1%. By comparison, the rest of the OECD (Organization of Economic Cooperation and Development) countries grew at a 3% rate through both of these two periods. When the foreign economies were growing faster than the U.S., its trade deficit naturally declined. What's notable now is this: the U.S. trade deficit has again been rising ever since the foreign economies began stalling. A rising trade deficit is now reversing the improvement that occurred when the U.S. economy fell into recession while its trading partners' economies were booming.

Another way to examine recent changes in the U.S. trade balance is by way of a simple equation: a country's current account deficit is the net balance between available total domestic savings on the one hand, and investments plus the budget deficit on the other. Both private saving and gross private domestic investment have fallen as a percentage of gross domestic product (GDP). Investment has declined much faster, falling from 16.5% of GDP in 1987 to 12.7% in 1991.

The one thing that did boom is the budget deficit, massively crowding out both investments and exports. Looking at the economy as a whole, the rising budget deficit had two obvious counterparts: sharply lower investment and a large and rising chronic current-account deficit.

MEASURING INTERNATIONAL COMPETITIVENESS

The American economy may appear to have gained in competitiveness as measured by relative labour unit costs or purchasing power. But, clearly, it has lost heavily in competitiveness through many years of underinvestment, if not disinvestment. . . what Wall Street euphemistically calls "restructuring," foolishly, welcoming and celebrating this disinvestment as a gain in productivity.

We have always looked at savings, investments and budget deficits as the determinants of long-term growth and currency strength. When the public sector soaks up a large and growing share of private

savings, there is less available for productive investment. Essentially, investment falls. That has happened in the United States and also Britain, Australia and Canada with a vengeance during the 1980s. But the United States is the very worst in this respect because its private savings are the lowest of these industrial nations.

From this point of view, the best indicator for an economy's long-term health and growth potential is net national savings (total private savings — household and corporate — minus government borrowing). A decline in national saving tends to lead to a comparable decline in net investment. U.S. net national savings have shrunk dramatically and are extremely low relative to Japan and Germany. Speaking of currencies, it should be clear that really strong currencies are underpinned by strong savings and investments while the reverse is true for weak currencies. We guess that after this year's new burst in the budget deficit, U.S. net national saving will be down to barely 1% of GNP, comparing dismally with savings of 10% of GNP in Germany and 20% in Japan.

ECONOMIES SLOWING EVERYWHERE

Worldwide, economic and monetary data point to a progressive slowdown in economic activity. After Japan fell prey to these conditions earlier in the year, it is now Europe's turn to succumb. Above all, German economic growth has virtually stalled. Both domestic demand and exports are weakening.

Reports from and about Germany have become downright gloomy. That's so for two different reasons: firstly, the economy's weakening has taken many by surprise; secondly and more importantly, the general realization of the unexpectedly high fiscal costs of unification have caused a general shock. From the point of view of the international investor, these developments raise two questions: Will the overconsumption in East German ultimately inflict serious structural damage on the West German economy as has happened to the Anglo-Saxon countries, and how do these developments in Germany compare with those in the U.S., Britain, Canada, and Australia?

There is quite a penchant to liken German unification with Reaganomics. Although very few realized that Reaganomics would eventually end up as a disaster for the U.S. economy and its currency, observers have been quick to jump to this conclusion for Germany and the D-mark. Yes, there is exactly the same policy mix — fiscal expansion coupled with a tight monetary policy. Nevertheless, there is a critical difference. America financed its soaring budget deficit by pulling in floods of foreign capital and still does. Germany by contrast, is financing its exploding fiscal deficit virtually entirely with its own savings.

The typical mistake in reports about Germany is the assertion that the Bundesbank raised its interest rates in order to attract foreign capital. The facts don't bear that out. Rates were raised for purely domestic reasons: to fight inflation and an excessive credit and money expansion. Ironically, net foreign purchases of German bonds have been rather modest in 1992. Only in July of this year did inflows start to surge. In most cases this inflow was a function of German investors who were trying to evade a newly-introduced withholding tax. They flocked to banks across the border in order to camouflage themselves as foreign investors who are exempted from this tax.

GERMANY'S BUDGET DEFICIT PROBLEM

Mainly due to unification costs, the German public sector deficit has soared from virtually zero in 1989 to about 5% of GNP in 1992. In addition to this higher deficit, in 1994-95, the German government will

also have to assume the huge liabilities of the former communist state and the various institutions that were created for the rebuilding of east Germany. As a result, total public sector debt will then jump from approximately 43% of GNP to about 60% of GNP. Interest costs will rise from 8% to 10% of total public expenditures.

Taking over the debts of the bankrupt communist states is really the same as the takeover of the S&L debts by the U.S. government. Many American economists consider these bailouts as mere bookkeeping transactions that have no economic relevance. Most Germans, though, find this burst of debts and interest costs quite real and refuse to take this lightly. So far, two postwar chancellors, Erhard and Schmitt, have been thrown out due to their debt excesses. Chancellor Kohl has every chance of being the next one. After ten years of effective and economically sound leadership and a masterful handling of German unification, he has proved to be utterly ill-suited at managing the longer-term economic, financial and psychological challenges of unification.

How does this all compare to other countries? Not to make light of Germany's problems, in the United States the federal deficit alone is running at 5% of GNP in 1992. Since 1980, the federal debt has jumped from 35% of GNP to fully 80% of GNP and interest costs now account for 15% of government outlays. In Canada, for example, more than a third of government expenditure is taken up with interest costs.

Although it's fashionable to do so, measuring budget deficits against GNP doesn't make any economic sense. The one and only proper measuring stick is available domestic savings. Clearly, a country with a high savings ratio (high savings as a percentage of GNP) can better afford a budget deficit than one with very low savings. In the United States, the current federal government deficit of around $300 billion vies with a supply of personal savings of only around $220 billion. Government borrowing requirements are in excess of available private household savings. In Germany, such savings — around DM 250 billion — far exceed public borrowing needs running presently at DM 180 billion.

Obviously, German fiscal problems pale beside the U.S. fiscal fiasco. The difference between these two countries is public opinion and reaction — complacency and indulgence in America, anxiety and protest in Germany. It is always the public's determined will for fiscal discipline that forces the government to take measures against the surging public deficit. In America, both Bush and Clinton are so scared of losing voters that they hardly make a peep about the budget deficit though it is America's biggest and most critical issue.

CONCLUSIONS

Looking at the world economy as a whole, there is nothing to cheer about. Contrary to the latest surge of optimism, the world business climate has deteriorated sharply over the past six to eight weeks. Recessionary forces have gathered momentum in Germany; in Japan, the Prime Minister has recently warned of a severe and prolonged downturn of the Japanese economy; and in Britain, the latest business survey paints a picture of near unrelieved gloom. In the United States, trends are worsening, too, only what one calls it is a matter of semantics — a continuance of recession or another faltering of a recovery.

These developments are in line with our expectations and forecasts. The world's economic and financial tribulations find their root in the excesses of the 1980s — the days when politicians and economists sung the virtues of permanent non-inflationary growth, all the while perpetrating unprecedented debt excesses, runaway asset inflation, and domestic and international imbalances. There's no turning back now, the

corner has been turned. Years of painful adjustments still lie ahead.

In the meantime, the financial and currency markets are being buffeted by a fast-changing maelstrom of perceptions and expectations which makes for a highly volatile environment. In our view, it's hopeless trying to capitalize on these short and fickle mood swings. What we can do is determine whether these movements are speculatively based or not, by riveting our focus on the surer implications of long-term fundamentals. From that perspective, investors are still better served preserving their capital.

The U.S. dollar could see its technical rally against the European currencies continue a little further before weakening again. Most of the mini-recovery rally is already over. The currency's long-term trend, in any case, is down.

As happens so often, markets are again under the orchestrated lure of another bout of false optimism over the U.S. As usual, it is accompanied by an over-pessimism on Europe. While many like to paint disaster on the recent currency turmoils in Europe, it was nothing more than an overdue adjustment which now paves the way for the lowering of German interest rates and then European rates.

We remain sceptical of long-term U.S. bonds given the exploding budget deficit and the massive speculation that has temporarily hyped the market. Foreign hard currency bonds — those of Germany and Switzerland, and one could include the bonds of Belgium, the Netherlands, and Austria as well — have outperformed U.S. bonds over the last two years and will continue to do so.

We remain relatively more optimistic on Europe than the rest of the world, both over the short- and long-term. Most European countries — the notable exceptions being Britain and Scandinavia — don't have the deep-seated and structural difficulties that lumber the Anglo-Saxon and Japanese economies. It makes the all-important difference between a short and healthy cyclical recession and long, painful, grinding periods of stagnation and depression.

The hard cold reality and the main operative for investors is this: the world economy is entering a synchronized downturn which making it worse for every single country. We doubt very much that the share markets have discounted this general economic deterioration, least of all the U.S. stock markets.

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